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In the Supreme Court of the United States

OCTOBER TERM, 1997

NACCO INDUSTRIES, INC., PETITIONER

v.

ROGER W. TRACY, OHIO TAX COMMISSIONER

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF OHIO

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether Ohio impermissibly discriminates against holders of federal obligations by requiring gains from the sales of United States bonds to be included in state taxable income while excluding from tax gains from sales of Ohio state and local bonds.

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INTEREST OF THE UNITED STATES

Substantial amounts of United States bonds are owned by taxpayers who reside in Ohio and who are subject to the tax laws of that State. In this case, the Ohio Supreme Court upheld the imposition of a state tax on gains realized from sales of United States bonds even though the tax is not imposed on gains realized from sales of Ohio state and local bonds. This discrimination in treatment between holders of federal obligations and holders of state obligations violates the intergovernmental immunity doctrine of the Constitution. The United States markets its securities throughout the Nation and has an important interest in assuring that the holders of its obligations are not subject to discriminatory state taxation.

STATEMENT

1. In 1982, petitioner paid $6,100,003 to purchase a fifteen-year U.S. Treasury Bond with a principal amount of $8,000,000 (Pet. App. 1a). Because this bond was backed by the full faith and credit of the United States government, petitioner was certain to realize a gain of $1,899,997 if the bond were held to maturity.[1] Petitioner could have incurred a loss from ownership of the bond only if interest rates increased after the date the bond was acquired *and* the bond was sold before it reached maturity.

Petitioner sold the bond in 1989 for $7,694,071. The sales proceeds included (i) a return of petitioner's investment of $6,100,003, (ii) accrued but unpaid interest on the bond in the amount of $126,575 and (iii) a realized gain from ownership of the bond in the amount of $1,467,493 (Pet. App. 1a).

2. Ohio imposes a corporate franchise tax that is computed on both a net worth and net income basis. Corporations are to pay "whichever produces the

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[1] The discount that petitioner paid from the face value of the bond was not "original issue discount" of the type that is treated as imputed interest income under the Internal Revenue Code. See 26 U.S.C. 1271-1275. The discount instead resulted from the operation of ordinary economic principles on the fact that market interest rates increased between the time that the bond was first issued and the time that it was purchased by petitioner. The difference between the purchase price of the bond and the price at which it was sold would therefore ordinarily be treated as a capital gain under the Internal Revenue Code. See 26 U.S.C. 1001(a). The fact that the gain was certain to occur if the bond had been held to maturity, however, makes the enhanced value obtainable from holding the bond to maturity analogous to additional interest payments on the bond.

greater tax" (Pet. App. 2a). In calculating the tax due on the net income basis, "[t]he initial base * * * is federal taxable income" (*ibid.*). From that initial base, corporations are permitted to "[a]dd any loss or deduct any gain resulting from the sale, exchange, or other disposition" of Ohio state and local bonds (*ibid.*, quoting Ohio Rev. Code Ann. § 5733.04(I)(6) (Anderson 1996)). Ohio law does not, however, permit a similar adjustment for the gains included in federal taxable income that are attributable to the sale, exchange or other disposition of United States bonds. As the Ohio Supreme Court recognized in this case, the result is that the "gain from the sale of an Ohio obligation is exempt from the Ohio franchise tax, while gain from the sale of a federal obligation is not" (Pet. App. 2a).

3. In reporting taxable income on its Ohio return for 1990, petitioner did not include the $1,467,493 gain that it realized that year from the sale of the federal bond. Petitioner asserted that the state tax statute violated the constitutional intergovernmental immunity doctrine, and 31 U.S.C. 3124(a), by discriminatorily imposing a tax on the gain from the sale of federal bonds while exempting from tax any similar gain on state bonds.[2] The Tax Commissioner of Ohio

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[2] 31 U.S.C. 3124(a) provides that:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except—
>
> (1) a nondiscriminatory franchise tax or another non-property tax instead of a franchise tax, imposed on a corporation; and

rejected petitioner's claim. The Ohio Board of Tax Appeals affirmed, noting that it lacked jurisdiction to consider any constitutional objections to the state tax (Pet. App. 12a-20a).

4. The Ohio Supreme Court affirmed (Pet. App. 1a-11a). The court first rejected the contention that the state tax violates 31 U.S.C. 3124(a). That statute generally prohibits state taxation "that would require the [federal] obligation, the interest on the [federal] obligation, or both, to be considered in computing a tax" (31 U.S.C. 3124(a)). The court concluded that this statute does not apply to the Ohio tax because the value of the federal bonds did not have to be considered in computing the tax (Pet. App. 5a). The court reasoned that the gain taxed by Ohio is determined by comparing the purchase and sale prices of petitioner's private transactions, not by considering the "obligation" of the United States under the bonds (*ibid.*).

In concluding that 31 U.S.C. 3124(a) is inapplicable to the challenged state tax, the court also relied on the difference in the language of that statute and 31 U.S.C. 3124(b). The court noted that 31 U.S.C. 3124(a)—which precludes various types of state taxation of federal obligations—makes no explicit reference to gains from transactions in federal obligations; by contrast, 31 U.S.C. 3124(b)—which provides for federal taxation of federal obligations—contains an explicit reference to gains from transactions in such obligations. The court reasoned that Congress acted "intentionally and purposely" by including the reference to gains from such transactions in one subsection while omitting it in the other (Pet. App. 4a,

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(2) an estate or inheritance tax.

quoting *City of Chicago* v. *Environmental Defense Fund*, 511 U.S. 328, 338 (1994)). The court concluded that, if Congress had "intended Section 3124(a) immunity to extend to gains from the sale of federal obligations, it would have expressed that intent in the statute" (Pet. App. 5a).

The Ohio Supreme Court further held that the Ohio statute does not unconstitutionally discriminate against the holders of federal obligations (Pet. App. 6a-11a). The court stated that a state tax that discriminates against the holders of federal obligations does not violate the Supremacy Clause if Congress has authorized the discrimination (Pet. App. 9a). The court held that by expressly precluding the States from imposing taxes on the principal or interest received from federal bonds under 31 U.S.C. 3124(a)—and not expressly precluding state taxation of gains realized from the sales of such bonds—Congress implicitly authorized the States to discriminate in their tax treatment of the latter (Pet. App. 9a).

The court further held that, even if it "must consider whether the tax is discriminatory," the Ohio tax would be valid (Pet. App. 9a). The court noted that an expert witness had testified at trial that "exclusion of gain from the sale of state obligations but not federal obligations would place federal obligations at a disadvantage in the market" (*id.* at 10a). The court stated, however, that the Ohio statute (by incorporating federal taxable income) permits *losses*, as well as gains, from sales of federal bonds to be considered in computing the state tax (*ibid.*). The court stressed that the expert witness had not expressed "an opinion on the relative marketability of the obligations when accounting for both gains and losses from the sale of federal obligations but not on state obligations"

(*ibid.*). The court stated that it was therefore "mere conjecture or speculation" whether Ohio's discriminatory treatment of holders of federal obligations affected "the relative marketability" of federal bonds (*ibid.*). The court held that such "speculation" could not support a conclusion that the Ohio statute violates the Constitution (*id.* at 11a).

ARGUMENT

1. The Ohio franchise tax unconstitutionally discriminates against the holders of federal obligations.[3] "A state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations." *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392, 397 (1983). See also *Moses Lake Homes, Inc.* v. *Grant County*, 365 U.S. 744 (1961); *Schuylkill Trust Co.* v. *Pennsylvania*, 296 U.S. 113 (1935).[4] By

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[3] The existence of "discrimination" in the state tax scheme is a required element for both the constitutional and statutory theories urged by petitioner. A state tax that falls within the scope of 31 U.S.C. 3124(a) is not invalid if it is "a nondiscriminatory franchise tax * * * imposed on a corporation" (*ibid.*). In cases in which the statutory and constitutional prohibitions both turn on the existence of discrimination, this Court has focussed on the extensive constitutional precedent that elaborates the nondiscrimination requirement. See, *e.g.*, *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392, 397 (1983); *New Jersey Realty Title Ins. Co.* v. *Division of Tax Appeals*, 338 U.S. 665, 672 (1950). The Court's decisions "have treated [the statute] as principally a restatement of the constitutional rule." *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. at 397. We therefore address only the constitutional issue in this brief.

[4] "[I]t still remains true, as it has from the time of *M'Culloch* v. *Maryland*, 4 Wheat. 316, that a state tax may not discriminate against the Government or those with whom it

taxing gains realized from sales of federal obligations but exempting similar gains realized from sales of state obligations, the Ohio tax "imposes a greater burden on holders of federal property than on holders of similar state property" and thus "impermissibly discriminates" against federal obligations (*Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. at 397).

a. The Ohio Supreme Court erred in concluding that, to establish the existence of discriminatory state taxation, the taxpayer has the burden of showing that the tax actually hinders the marketing of federal securities (Pet. App. 10a). The decisions of this Court do not support that proposition.

The Ohio Supreme Court noted that, in *Willcuts* v. *Bunn*, 282 U.S. 216 (1931), this Court stated that a tax on gains from the sale of government bonds does not necessarily disadvantage the marketing of such bonds if "there is also a deduction for losses on sales" (Pet. App. 8a, quoting 282 U.S. at 231). In upholding application of the federal income tax to gains realized from sales of state bonds in *Willcuts*, the Court rejected the assertion that such a tax unconstitutionally interfered with "a function of government" (Pet. App. 11a). The Court emphasized, however, that the federal tax involved in *Willcuts* was "nondiscriminatory" because it applied equally to gains from sales of federal and state bonds. 282 U.S. at 227. In upholding such nondiscriminatory taxation, the Court did not suggest in *Willcuts* that the victims of *discriminatory* taxation would be required to establish that the tax adversely "affects a function of

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deals." *Phillips Chemical Co.* v. *Dumas Independent School District*, 361 U.S. 376, 387 (1960).

government" (Pet. App. 11a), as the court erroneously held in this case.[5]

The Ohio Supreme Court also erred in relying (Pet. App. 10a) on *Rockford Life Insurance Co.* v. *Illinois Department of Revenue*, 482 U.S. 182 (1987). In that case, this Court upheld application of a nondiscriminatory state property tax to bonds that were issued by private institutions and guaranteed by the United States. The Court stated that the possibility that the United States would have to honor its guarantee was too speculative to warrant the conclusion that such bonds were "obligations" of the United States to which constitutional immunity attaches. *Id.* at 190. That holding does not support the conclusion of the court below that the evidence in this case is insufficient "speculation" (Pet. App. 10a) to support a finding of discrimination.

b. Indeed, the Ohio Supreme Court acknowledged that the evidence in this case establishes that the state tax on gains realized on federal bonds, and its

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[5] The question whether a state tax "discriminates against federal obligations" (*Nebraska Dep't of Revenue* v. *Loewenstein*, 513 U.S. 123, 135 (1994)) is separate from the question whether the state tax violates "the intergovernmental tax immunity doctrine" by "taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability" (*id.* at 136). In *Loewenstein*, the Court rejected a claim of discrimination because the State treated income derived from state and local obligations no differently than it treated income derived from federal obligations. *Id.* at 135-136. The Court then rejected the further claim that the state tax unconstitutionally interfered with "the borrowing power" of the United States because there was "no evidence in the record that the taxation at issue will impair the market in federal securities or otherwise impair the borrowing ability of the Federal Government." *Id.* at 137.

exemption for gains realized on state bonds, discriminates against holders of federal bonds (Pet. App. 10a). Nothing about that evidence involves "mere conjecture or speculation" (*ibid.*). What *is* merely "conjecture or speculation," however, is the state court's suggestion that a compensating benefit to the holders of federal bonds *might* occur because state law permits losses on sales of federal bonds to be recognized under the state tax but does not allow losses on sales of state bonds to be so recognized.

In the first place, there is no authority for the court's proposition that an established discrimination against a holder of federal property may be permitted because of the speculative possibility that a compensating advantage might exist elsewhere in the state tax scheme in some other year or for some other holder of federal property. Such an unmanageable proposition has never been adopted by this Court. Indeed, as petitioner notes (Pet. 19-20), similar propositions have been rejected by the Court in analogous constitutional contexts involving state taxation.

Moreover, the Ohio Supreme Court erred in assuming that a state taxpayer would, by incorporating federal taxable income under the state statute, obtain a compensating advantage from any "losses" realized from sales of federal bonds. Net losses from the sales of government bonds would not be a component of federal taxable income for corporate taxpayers because the Internal Revenue Code specifies that, "[i]n the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges" (26

U.S.C. 1211(a)).[6] The concept of federal taxable income that is incorporated for state tax purposes under Ohio law thus may include a net gain from transactions in capital assets but, under 26 U.S.C. 1211(a), it will not include a net loss. The Ohio Supreme Court thus erred in concluding that a taxpayer would, by incorporating federal taxable income under the state statute, obtain an advantage from net losses that could offset the disadvantage incurred by discriminatory state taxation of net gains on the sales of federal bonds.

Both for corporate and individual taxpayers (see note 6, *supra*), the state tax discriminates directly against the holders of federal bonds by requiring inclusion of gains on sales of federal bonds while excluding gains on state bonds. There is no compensating advantage "when accounting for both gains and losses" (Pet. App. 10a). Even if it were conceptually possible for a State to justify discriminatory treatment of federal obligations by some compensating advantage otherwise provided under state law—a conclusion that this Court has never reached—the State has not sustained its burden of doing so on the record of this case.[7]

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[6] Losses from such transactions for corporations may be carried back three years and carried forward five years to be offset against gains in other periods. 26 U.S.C. 1212(a). A net loss is not reflected in federal taxable income, however, for any period. By contrast, individuals may report a net loss from such transactions, but only up to the amount of $3000 in any year. 26 U.S.C. 1211(b).

[7] For the reasons summarized by petitioner (Pet. 14-15), the Ohio Supreme Court plainly erred in suggesting (Pet. App. 9a) that, in enacting 31 U.S.C. 3124(a), Congress implicitly author-

2. The decision of the Ohio Supreme Court in this case is of broad recurring importance. Other States either have imposed, or could impose, similar tax schemes that advantage their own obligations by disadvantaging those of the United States. See Pet. 20. In holding a similar state tax provision unconstitutional, the Maryland Court of Special Appeals recognized that taxing gains from federal obligations while exempting gains from state obligations "diminish[es] the investment attractiveness of the United States obligations in favor of state obligations." *Doneski* v. *Comptroller*, 605 A.2d 649, 653 (1992), cert. denied, 506 U.S. 1054 (1993). A state tax that discriminates against the holders of federal bonds interferes with the extraordinarily important federal function of marketing trillions of dollars of United States obligations. Review by this Court is warranted to ensure that States are not permitted to favor their own obligations by discriminating against those of the National government.

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ized discriminatory state taxation of gains from sales of federal securities.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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